4 ECONOMY

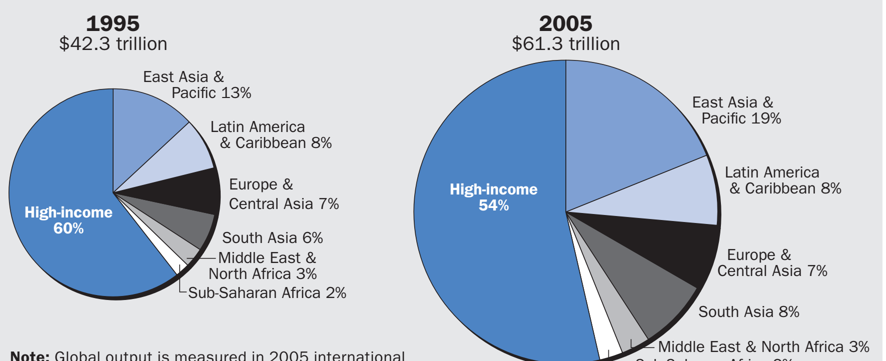
A portrait of the global economy

A portrait of the global economy and the activity of more than 200 countries and territories that produce, trade, and consume the world's output—that is what the data in this section provide. Timely and reliable macroeconomic statistics are important for three reasons. First, they provide a measure of the wealth of economies, reflecting the welfare of their residents and prospects for future growth. Second, because the design of sound macroeconomic policies requires an understanding of historical patterns and trends, they provide guidance in shaping development policies. Third, they inform consumers, workers, investors, taxpayers, voters, and citizens on how their economy is managed so that they can make appropriate choices and exert control over their governments.

Developing economies grew faster over the last decade (1995–2005) than in the two previous decades and faster than high-income countries. World output in 2005 amounted to about $61 trillion, measured in purchasing power parities. This was a 45 percent increase over 1995, when the world output was $42.3 trillion (figure 4a). The share of developing economies in global output increased from 39 percent to 46 percent. The developing economies in the East Asia and the Pacific region grew the most, doubling their output and increasing their share of global output from 13 percent to 19 percent.

Further integration into world markets, better functioning internal markets, and rising demand for many commodities all contributed to the acceleration of growth in developing countries. Past periods of growth were often interrupted by financial or balance of payments crises. Indeed, from 1997 to 1998 some of the fastest growing economies experienced a major financial crisis, which started in Asia and spread to the transition economies of Europe and Central Asia. But recovery from this crisis has been widespread and durable. Developing economies are running lower fiscal and external deficits, accumulating larger reserves, and adopting more cautious monetary and financial policies. These policies make economies less vulnerable to shocks and less volatile, increasing the confidence of investors. The financial shocks of the period also revealed the importance of reliable, publicly available data for monitoring the actions of governments and private agents.

Developing economies increase their share of global output **4a**



Note: Global output is measured in 2005 international dollars (GDP in purchasing power parity terms).
Source: World Bank staff estimates.

Long-term trends

Developing economies are expected to grow faster than high-income economies. The surprise is that they often don't. Labor surpluses and higher returns to physical capital in developing countries, along with ready access to technology already developed and amortized in high-income countries, are among the reasons that developing economies are expected to grow faster and, in the long run, close the gap with richer economies. But until recently only a few developing economies enjoyed sustained periods of high growth. And even fewer have reached the average growth of the high-income economies. Poverty traps, exclusion from global markets, and government and market failures are some of the reasons put forward to explain the failure to converge.

The last decade brought a change, however. The average growth of low- and middle-income economies surpassed that of high-income economies (figure 4b). The most successful are no longer counted as "developing." During this period 13 countries graduated from the World Bank's classification of low- and middle-income economies: Antigua and Barbuda, Bahrain, Greece, Guam, Isle of Man, Republic of Korea, Malta, New Caledonia, Northern Mariana Islands, Puerto Rico, Saudi Arabia, San Marino, and Slovenia. But these are only a few, and they account for less than 2 percent of the world's population. Growth is still uneven (figure 4c). Global and regional averages are driven by a few large countries, which carry large weights in the aggregate measures.

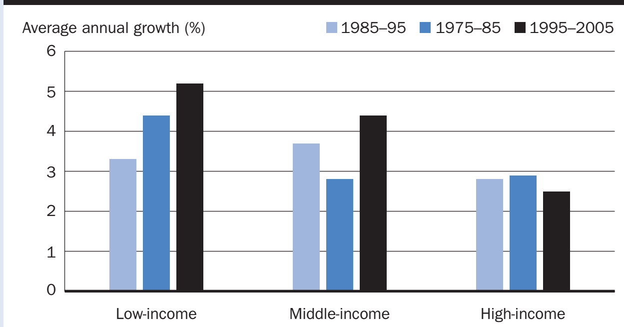
Better policies to achieve macroeconomic stability

The high growth experienced in the developing world was due in part to expanding trade (section 6) and a better investment climate (section 5). The very rapid industrialization of large countries such as China and India also benefited the exporters of primary commodities—oil, metals and minerals, and agricultural produce.

Macroeconomic stability also helped. Since the high inflation and the debt crises of the 1970s and 1980s, better fiscal, monetary, and exchange rate policies have brought inflation rates down in most developing countries. And the very rapid inflation in European and Central Asian countries after the collapse of the Soviet Union came back to earth after their transition from central planning to market economies (figure 4d).

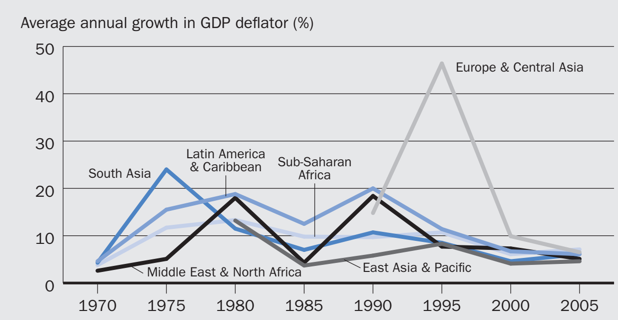
Macroeconomic stability, one factor in a favorable investment climate, promotes economic growth (figure 4e). But low inflation does not always lead to high economic growth. In general, developed economies have lower inflation and economic growth rates. The median inflation rate was below 10 percent in all developing regions, well below the median of around 15 percent or higher in 1990 in three regions.

Growth is accelerating in the low-income economies 4b



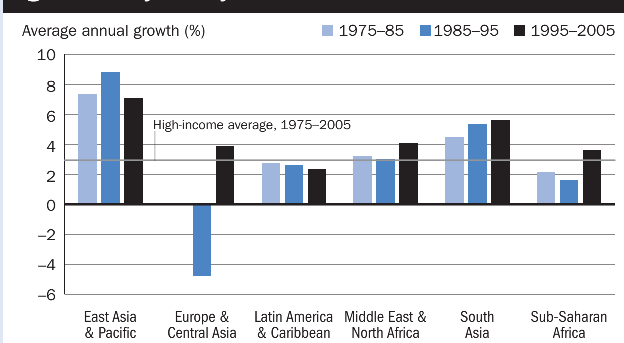
Source: World Bank data files.

Inflation is now less than 10 percent in all developing regions 4d



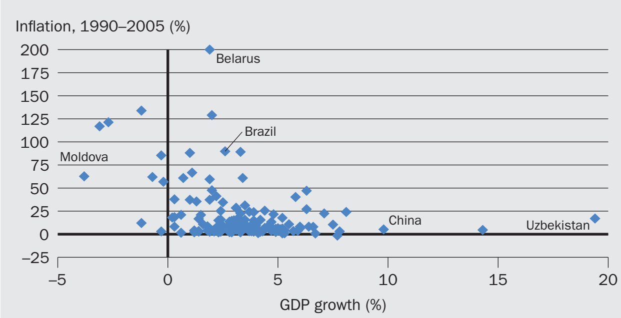
Source: World Bank data files.

Patterns of regional growth vary widely 4c



Source: World Bank data files.

Economies with high growth rates generally have lower rates of inflation 4e



Source: World Bank data files.

Rising reserves

Trade surpluses and growing workers' remittances have allowed many developing countries to accumulate large holdings of reserve assets over the past five years. One motive may be the desire to maintain larger precautionary reserves to protect against financial and balance of payments crises. Indeed, the globalization of financial transactions may have made countries with open capital accounts more vulnerable.

China, India, and the Russian Federation are now among the top 10 economies with the largest reserves holdings (table 4f). Together they accounted for 25 percent of the world reserves in 2005. In contrast, the United States holds only 4 percent of the world reserves. With one exception in 1991, the current account deficit of the United States increased steadily from around $12 billion in 1982 to $792 billion in 2005. The U.S. current account deficit is financed largely by China's current account surplus and growing investments by major oil exporters.

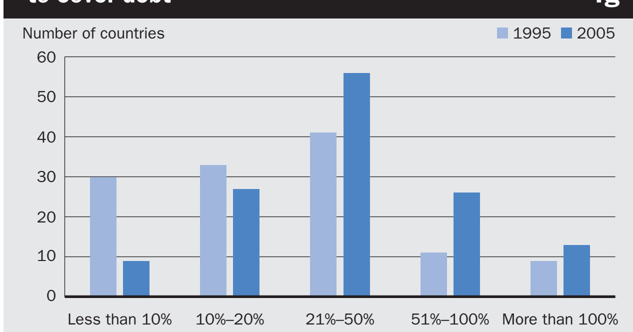
Large reserve holdings also make economies less vulnerable to debt crises, reassuring lenders and lowering interest rates. Economies with large reserves are less likely to require assistance from lenders of last resort, such as the World Bank or International Monetary Fund (IMF). Since 1995 the ratio of reserves to external debt has increased for many economies (figure 4g).

Top 10 economies with largest reserves — 4f

Economy	International reserves $ billions 2004	International reserves $ billions 2005	Share of world total (%)	Increase over 2004 (%)	Reserves (months of import coverage)
Japan	844.7	846.9	18	0.3	16
China	622.9	831.4	18	33.5	14
Taiwan, China	247.7	260.3	6	5.1	14
Korea, Rep.	199.2	210.6	5	5.7	8
United States	190.5	188.3	4	–1.2	1
Russian Federation	126.3	182.3	4	44.4	11
India	131.6	137.8	3	4.7	12
Hong Kong, China	123.6	124.3	3	0.6	4
Singapore	112.2	115.8	3	3.2	5
Germany	97.2	101.7	2	4.6	1

Source: International Monetary Fund and World Bank data files.

More reserves to cover debt — 4g



Source: World Bank and International Monetary Fund data files.

External public debt relief

Improvements in macroeconomic management of the poorest countries have also paved the way for more extensive debt relief.

Since 1996 developing countries have benefited from debt writeoffs by official donors and will continue to do so. It makes sense to relieve debt when the causes of excessive indebtedness are being tackled at their roots and when the benefits of debt reduction are directed toward more effective poverty reduction programs.

Making debt sustainable for poor countries is one of the Millennium Development Goals. Debt can bridge financing gaps and meet investment needs for projects with high social returns. But when unsustainable, it obliges countries to undertake policies that might be disruptive and harmful for growth and welfare, such as default, large fiscal adjustments, and devaluation.

In 2005 the external debt of developing countries amounted to $2,730 billion, and related debt service (principal and interest) to $513 billion. The debt stock has been declining in most regions and, accordingly, debt service declined. The ratio of debt service to exports in 2005 was 13.8 percent, the lowest in the last 20 years. The ratio of total external debt to GDP declined from nearly 6.6 percent in 1999 to 5.4 percent in 2005.

The debt crises of the 1980s and 1990s were the result of excessive borrowing with overly optimistic expectations. But cyclical global recessions, declining agricultural commodity prices, and conflicts also left many poor countries unable to service their debt. Traditional debt relief, based on rescheduling and restructuring of payments, proved ineffective for them.

Special programs to address the problems of the poor countries with predominantly official creditors were started in 1996, when the World Bank and the IMF launched the Heavily Indebted Poor Countries (HIPC) Initiative. The initiative aims to provide permanent relief from unsustainable debt by redirecting the resources for debt service toward social expenditures aimed at poverty reduction. The initiative relieved $61 billion in total nominal debt service for 29 countries, and another 11 countries are eligible for additional debt relief.

The debt stock of the 29 HIPCs was reduced by 90 percent and their debt service by 2 percent between 1999 and 2005. And as a direct result of debt relief, public expenditures in education and health have increased by 3 percent in these countries.

The International Development Association (IDA), the IMF, and the African Development Fund have committed to cancel an additional debt stock of $49 billion for all HIPCs under the new Multilateral Debt Relief Initiative in 2006. IDA has since canceled $27 billion and the IMF $3 billion for 19 countries that have made progress in their economic and social reforms.